



MARKET OVERVIEW

The year started off on a positive note with the SA Listed Property Sector ("SAPY") delivering a total return of +1.63% for the month. Emerging markets were in favour, with our local Equities up +4.31%, Bonds up +1.33% and even the ZAR +1.71% stronger against the USD. However, as the month drew to a close, local political headwinds once again became apparent as rumours circled surrounding a potential cabinet reshuffle. On the global front, the swearing in of Trump as the 45th American president dominated headlines, however post inauguration, the markets optimism around his ability to get the US back on track seemed to have died down; supporting the case for a more contained bond yield and thus supporting listed property prices.

The focus on the politics above is really a factor of January being a quiet month on the ground in terms of data whereas February will see results starting to come in and evidence as to how December retail sales fared or how many smaller tenants decided it was an option to clean out their premises and abscond from their leases. Our initial discussions with management teams gave us 'more of the same'; the market was still challenging across the board and that they needed a combination of stronger GDP, market confidence and political stability to justify an acceleration from current levels. In terms of listed property returns the same is true. There is certainly value in the market, which can be realised holding the status quo, i.e. put the politics aside and let us do our jobs.

The question is what is our job? Ours is to provide index beating returns at an appropriate level of risk. We do this by evaluating each company on its merits and determining what is an appropriate price to pay for the earnings stream. The underlying company's job on the other hand should be to deliver a sustainable earnings stream. Our concerns, however have been that over the last few years, where core earnings have justifiably slowed in light of softer economic growth, distribution growth has accelerated. The only way to rationalize this is that several of these companies have been paying out non-recurring earnings or earnings derived from non-property activities. This would be in the form of foreign currency gains, refinancing debt at lower rates, fee income or even profit earned on loans to SPVs. Not only are these non-recurring in that they are difficult to replicate the previous year's growth, but they also inflate the base off which the following year's earnings grow. And the worst case scenario is when they actually revert, i.e. assume a stock paid out foreign currency profits in 2016 up circa 15% only to see this as a loss should the rand strengthen into 2017. This year will see several companies exposed which brings us back to our job, identifying these stocks in order to avoid the risk and provide an appropriate index beating return.



BENCHMARK PROPOSALS

In 2003 the South African Property Index ("SAPY") came into existence as the bellwether for anyone wanting to invest in "SA listed property". Nearly 14 years later and over 1100% returned (annualised at 21%), the SAPY and the underlying asset class is no longer a marginalised sector lacking coverage and liquidity, but a serious contender fighting for its fair share in just about any balanced portfolio. Liquidity can no longer be a point of contention as the market cap sits just below R500 billion with the potential to grow dramatically if the proposed changes below are implemented.

Chart 1: SAPY market cap evolution: 2006 - 2016



Source: Bloomberg

Interestingly, when the SAPY was launched it implemented certain rules to exclude the 'elephant in the room' at the time: Liberty International. This, we believe, was done for two reasons: 1) the company was too big and dominant in the current index and 2) all of its assets were offshore so it wasn't technically an "SA listed property" company. The company was excluded on the basis that it did not have a primary listing on the JSE. As time passed and the index evolved we started noticing a stronger push towards geographic diversification across portfolios to the extent that entire listings of pure offshore portfolios started popping up. First it was Redefine International, followed by NEPI and before we knew it the SAPY stands today with 5 of the 20 constituents being pure offshore companies, with a further 15 trading on our exchange.



The question being asked from this was, why do some offshore stocks make it onto the SAPY while others are excluded? Well, we answered this above with regards to the stock's primary listing and where the majority of trade happens, but is this fair and representative of what our exchange has to offer?

With the discussion around the appropriateness of the SAPY becoming more frequent, the JSE published a 'white paper' at the end of 2016, proposing a complete revamp of the property index suite. Three new indices have been proposed – we summarise the proposal and will shed some light on our preferred index below:

1. SA REIT Index

This index will include only JSE listed companies that are classified as SA REITs. In effect it would be somewhat like the existing SAPY, but exclude all dual listed companies, such as NEPI, Rockcastle, MAS and Stenprop as well as developers such as Attacq.

It would be an attractive yielding index with a strong SA bias, however we feel for our purposes it would be somewhat limited and quite homogenous with little opportunity for adequate diversification. It would also have much higher concentration risk than the current SAPY.

2. Tradable Property Index

Based on current statistics, this index would include the 13 most liquid property companies on the JSE (i.e. they would need to pass certain liquidity criteria), regardless of where the primary listing is.

This would be appropriate for tracker funds, but once again very limiting with regards to choice and could push undesirable behaviour as companies may chase size and liquidity at the expense of earnings.

3. All Property Index

This index will include all property companies listed on the JSE that are included in the All Share Index (currently 30), including both foreign and local, REITs and developers. The foreign companies will be included based on SWIX weightings (i.e. on what is held on the South African exchange).

We believe that this index would be the most appropriate 'replacement' for the SAPY as it incorporates more choice and at the same time lowers concentration risk. We do however believe that it needs to be 'tweaked'.



In our submission to the JSE, we have proposed that the ALPI should form the basis of the new-SAPY. **However, in order to ensure that the new-SAPY remains relevant as both a South African and a Listed Property / REIT benchmark, we have made the following suggestions:**

- 1. Limit the constituents to 25:** We are still of the view that inclusions should be relevant and tradable. The 'tail' of the index at 30 constituents is very small and subject to be price movements on very small and infrequent trades.
- 2. Cap the maximum weight of any single stock to 15% to limit concentration risk:** This was a suggestion in the 'white paper' to which we concur. For the index to serve its purpose, it must have a healthy spread of stocks and highly concentrated positions would undermine this.
- 3. Cap the maximum weight of any stock that is not an SA REIT to 5%:** This ensures that the SAPY remains relevant as both a Listed Property / REIT and a South African benchmark as companies that do not pay a yield (such as developers) as well as those domiciled outside of SA will have a capped exposure in the index.

We have seen the propensity for local investors to perhaps over value offshore stocks premised on their fear for the rand and / or the current political climate. We fear that offshore companies may look to capitalise on this mispricing and potentially crowd out our local stocks. After all, the SAPY is a South African Index and we would not want to prejudice local companies looking to raise capital in their own backyard.

In addition, we feel that local listed property investors have always been tilted towards the attractive yield proposition of the asset class, which is often diluted by offshore stocks and developers and are not governed by the same regulations in our local REIT regime, which obliges companies to pay out the majority of operating earnings.

Ultimately, we think that the JSE has taken positive steps to realign and make the SAPY more relevant in light of current market conditions and requirements. We look forward to the potential universe growing and allowing us to apply our skill set towards generating returns across a wider universe. Initial changes in the SAPY will likely trigger material changes across many managers portfolios as their benchmarks may be adjusted, which could create short term trading opportunities, however the real opportunity is more strategic and long term in nature as the greater liquidity and more efficient stock allocation should enhance the quality of investment portfolios in light of risk and return.



LOOKING FORWARD

We are still confident that 2017 can deliver high single digit returns and just as confident that mid to long term returns should be marginally better than that. We are however cautioning the quality of earnings across certain companies that have held up previous distributions with non-recurring items and have relied on a significantly weaker ZAR. This will likely be a theme rolling out over the next year or two as specific companies disappoint leading to more importance on active management and stock selection. The roll out of the 'new SAPY' should provide us with greater opportunity to avoid several of these cases as we have more stocks to select from.



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